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# In the Supreme Court
OF THE
## United States

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OCTOBER TERM, 1944

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No. [redacted] 85

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LORIN A. CRANSON,
*Petitioner,*
vs.
THE UNITED STATES OF AMERICA,
*Respondent.*

**PETITION FOR WRIT OF CERTIORARI**
**to the United States Circuit Court of Appeals**
**for the Ninth Circuit**
**and**
**BRIEF IN SUPPORT THEREOF.**

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## Subject Index for Petition for Writ of Certiorari

## Table of Cases Cited in Petition for Writ of Certiorari



## Table of Statutes Cited in Petition for Writ of Certiorari

## Subject Index for Brief

Page

## Table of Cases Cited in Petitioner's Brief

## Table of Statutes Cited in Petitioner's Brief



## Table of Treasury Regulations Cited in Petitioner's Brief

## Texts Cited in Petitioner's Brief

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**for the Ninth Circuit.**

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*To the Honorable Harlan Fiske Stone, Chief Justice of the United States, and to the Honorable Associate Justices of the Supreme Court of the United States of America:*

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered January 24, 1945, rehearing denied February 26, 1945 (R. 76), which affirmed the judgment of the United States

District Court for the Northern District of California, Southern Division, entered October 25, 1943. (R. 62.)

## OPINION BELOW.

The opinion of the Court below, filed January 24, 1945, is reported at 146 F. (2d) 871, and a copy will also be found in the printed Transcript of Record at pages 71 to 74. No opinion was rendered by the District Court.

## BASIS OF JURISDICTION.

The jurisdiction of this Court is invoked under section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938. (Appendix, p. i.)

The judgment of the Circuit Court of Appeals for the Ninth Circuit was filed January 24, 1945 (R. 75); petition for rehearing was filed February 20, 1945, and denied on February 26, 1945. (R. 76.)

## SUMMARY STATEMENT.

This is a test case brought on behalf of all stockholders of Honolulu Oil Corporation for the purpose of determining the taxability of dividends declared by that corporation during the calendar year 1936. Two companion test cases, which will be controlled by the disposition of this case, have been filed to deter-

mine the taxability of dividends declared during the calendar years 1937 and 1938.

All three cases involve the same fundamental question of law which may be generally stated as follows: Where a corporation undertakes a new venture through the formation of a wholly owned subsidiary corporation, and the subsidiary is operated at a loss and is thereafter liquidated and dissolved, do the earnings of the parent corporation available for dividends remain forever undiminished by this unprofitable venture, with the result that distributions which are admittedly returns of capital are taxed to the stockholders as income?

The facts with respect to this petition are that petitioner received during the calendar year 1936 dividends from Honolulu Oil Corporation in the sum of $450.00 and reported the full amount thereof as subject to income tax. (R. 28-29.) Thereafter petitioner filed claims for refund based on the ground that $432.00 of said dividends were not paid out of earnings or profits and were not taxable to petitioner. (R. 29-30.) After the disallowance of said claims (R. 30), suit was filed in the District Court and the case was tried upon stipulated facts, the essential facts being as follows:

Honolulu Consolidated Oil Company was incorporated in 1910 under the laws of the State of California. In 1930 it was reincorporated under the laws of the State of Delaware as Honolulu Oil Corporation, Ltd. In 1937 the name of the corporation was changed

to Honolulu Oil Corporation. Both of said corporations will be referred to as "Honolulu." (R. 31.)

On August 31, 1936, Honolulu liquidated three wholly owned subsidiary corporations, hereinafter in this Summary Statement referred to as "Subsidiaries," and took over all their assets and assumed their liabilities. The liquidation of said wholly owned Subsidiaries was carried out under the nontaxable provisions of section 112(b)(6) of the Revenue Act of 1936. (Appendix, pp. ii-iv.) (R. 33.) One of said wholly owned Subsidiaries was California Exploration Company, Inc., which corporation resulted from the consolidation in 1934 of two prior wholly owned subsidiary corporations of Honolulu which had been formed by Honolulu to acquire and develop prospective oil properties in the States of Wyoming and Texas. (R. 31-32.) Another of said wholly owned Subsidiaries was Sea Cliff Development Company, Ltd., which had been formed by Honolulu to acquire and develop prospective oil properties in Ventura County, California. The third wholly owned subsidiary, Processco, Limited, was formed by Honolulu primarily to acquire and develop patents relating to the processing of crude petroleum. (R. 32.)

Each of said wholly owned Subsidiaries sustained operating losses during the period from their incorporation to their dissolution. In the case of California Exploration Company, Inc., both its predecessors also sustained operating losses up to the date of their consolidation in 1934, which operating deficits were carried forward on to the books of the consoli-

dated company, California Exploration Company, Inc. The total operating deficits of said three wholly owned Subsidiaries as of the date of their liquidation on August 31, 1936, was $1,205,451.61. (R. 36-37.)

Upon the liquidation of said wholly owned Subsidiaries and the transfer of all their assets to Honolulu, Honolulu realized a loss of $1,225,908.63.[1] (R. 33.)

In 1936, the year involved in this petition, Honolulu paid cash distributions to its stockholders in the amount of $1.00 on each of its outstanding 937,743 shares of capital stock, or a total cash distribution of $937,743. (R. 38.) On January 1, 1936, Honolulu had available for dividends accumulated earnings or profits in the amount of $139,631.26. Honolulu's earnings or profits during the calendar year 1936 amounted to the sum of $931,553.82 before deducting any portion of said loss realized upon the liquidation of said Subsidiaries in the amount of $1,225,908.63, or before deducting the total operating deficits of said Subsidiaries in the amount of $1,205,451.61. (R. 38.)

Since Honolulu admittedly realized a loss of $1,225,908.63 upon the liquidation of the Subsidiaries in 1936 and since this loss was sufficient to eliminate not only Honolulu's normal 1936 earnings of $931,553.82, but also the earnings as of the beginning of the year in the amount of $139,631.26, it follows that the divi-

[1] The difference between this loss of $1,225,908.63 and the total operating deficits of the Subsidiaries in the amount of $1,205,451.61, referred to in the previous paragraph, is due to a payment of $20,457.02 made by Honolulu to third parties for a contingent interest in the capital stock of Processco, Limited. (R. 34.)

dends paid by Honolulu in 1936 were actually distributions of capital and not income to the recipients, except to the extent that effect must be given to the accumulated earnings as of January 1, 1936.[2] The same result would follow if the earnings of Honolulu available for dividends were reduced by the operating deficits of the Subsidiaries as of the date of their liquidation.

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**QUESTIONS PRESENTED.**

The fundamental question for decision in this petition is whether the operating deficits of said wholly owned subsidiaries as of the date of their liquidation in 1936, in the aggregate amount of $1,205,451.61, were inherited by Honolulu upon the nontaxable liquidation of said subsidiaries in accordance with the principle of *Commissioner v. Sansome,* 60 F. (2d) 931 (C.C.A. 2), certiorari denied, 287 U.S. 667, thus resulting in a reduction of the earnings of Honolulu available for dividends; or, in the alternative, whether the loss realized by Honolulu upon the liquidation of said subsidiaries in 1936, in the amount of $1,225,908.63, reduced the earnings of Honolulu available for dividends.

Petitioner's principal contention is that the operating deficits of the wholly owned subsidiaries were in-

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[2] It would appear that the accumulated earnings as of January 1, 1936, in the amount of $139,631.26 should be reduced by the loss for the year 1936 prorated on a daily basis to March 14, 1936, the date of the payment of the first dividend, and that the remainder of said accumulated earnings would then be available for the payment of that dividend. The remaining three dividends in 1936 were entirely paid out of capital.

herited by Honolulu upon the nontaxable liquidation of said subsidiaries. In this connection, petitioner asserts that the Court below erred in the following respects:

(1) In deciding that the operating deficits of the subsidiary corporations as of the date of their liquidation in 1936 did not diminish the earnings or profits of Honolulu which were otherwise available for dividends.

(2) In assuming that it was necessary for petitioner to prove what portion of the deficits of the subsidiaries occurred in the tax year 1936.

In the alternative, petitioner contends that the loss actually realized by Honolulu upon the liquidation of the subsidiaries in 1936 reduced the earnings of Honolulu available for dividends, that section 501 of the Second Revenue Act of 1940 (Appendix, pp. vi-viii), if applied to the facts of this case, violates the provisions of the Sixteenth Amendment to the Constitution of the United States, and that the retroactive application of this section for a period of more than four years is a violation of the due process clause of the Fifth Amendment to the Constitution of the United States. In connection with this alternative contention petitioner asserts that the Court below erred in the following respects:

(1) In dismissing this alternative contention without consideration on the ground that there has been no showing that any of the loss sustained by Honolulu upon the liquidation of its subsidiaries was incurred in the tax year 1936. It is stipulated that the sub-

sidiaries were liquidated on August 31, 1936, and that upon said liquidation Honolulu realized a loss of $1,225,908.63, the entire amount of the loss in question. (R. 33.)

(2) In stating that it is admitted that $931,553.82 earnings or profits were made in 1936 by Honolulu. It is stipulated that these are the earnings before deducting the loss of $1,225,908.63 realized in 1936 upon the liquidation of the subsidiaries. (R. 38.)

## REASONS FOR GRANTING THE PETITION.

1. The Circuit Court of Appeals for the Ninth Circuit has decided an important question of Federal law which has not been but should be settled by this Court. This decision, although not directly in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Commissioner v. Sansome,* 60 F. (2d) 931 (C.C.A. 2, 1932), certiorari denied, 287 U.S. 667, does conflict with the principle upon which the decision in that case is based. That principle is that corporate reorganizations which result in no recognized gain or loss under the reorganization section of the Revenue Acts (section 112 of the Revenue Act of 1936 and of the Internal Revenue Code) do not interrupt the company's life as a continued venture under the dividend section of the Revenue Acts (section 115 of the Revenue Act of 1936 and of the Internal Revenue Code) with the result that the earnings or profits of the transferor are inherited by the transferee.

The recent decision of this Court in *Commissioner v. Wheeler*, ....... U.S. ...... (March 26, 1945), makes it of general importance in the administration of the revenue laws for this Court to determine whether it will give its sanction to the doctrine of the *Sansome* case, and decide further that that doctrine is applicable to operating deficits as well as earnings, or whether this Court will determine that its decision in the *Wheeler* case is not applicable to nontaxable liquidations of subsidiary corporations. In the *Wheeler* case this Court approved as valid a Treasury Regulation providing that gains and losses are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under section 112. (This regulation has now been enacted into law by section 501 of the Second Revenue Act of 1940.) (Appendix, pp. vi-viii.) The basis of the decision in the *Wheeler* case is that recognition of gain or loss for tax purposes is deferred and that when taken account of for tax purposes at a later time the effect upon earnings or profits available for dividends can at that time likewise be taken into account. But this is not true with respect to nontaxable liquidations of subsidiary corporations, where the recognition of gain or loss is *not* merely deferred—it is *never* entirely recognized for tax purposes,[3] and may, as in the instant case, receive no recognition whatever. This is so because the basis section of the statute (section 113(a)(15) of the Revenue Act of 1936 and of the

[3]This is true unless the subsidiary's operations have resulted in neither realized gain nor realized loss. See discussion and examples infra, pages 37 to 45.

Internal Revenue Code (Appendix, p. v)) provides that the basis of the property received by the parent from the subsidiary remains the same as it was in the hands of the subsidiary. If this section had provided that the basis to the parent of the property received from the subsidiary should be the same as the basis to the parent of the subsidiary's *stock*, then the recognition of gain or loss to the parent would have been deferred and would be entirely realized later upon disposition by the parent of the subsidiary's property, and at that time the earnings or profits of the parent would reflect the proper adjustment.[4] But since gain or loss to the parent is never entirely recognized, the proper adjustment to the earnings or profits of the parent, if it is ever to be made, must be made at the time of actual realization upon liquidation. This can be accomplished either by approving the doctrine of the *Sansome* case, including therein operating deficits as well as earnings, or by a decision that the regulation approved in the *Wheeler* case is unreasonable and invalid and section 501 of the Second Revenue Act of 1940 unconstitutional when applied to the nontaxable liquidation of subsidiary corporations.

2. If all stockholders of Honolulu have filed claims for the three years, 1936, 1937 and 1938, the total refund claims which will be controlled by the decision in this case will exceed 6600. Each of the stockholders was advised that these test cases would be filed and

[4]But such a provision would result in double taxation, the parent paying a tax on gains already taxed to the subsidiary. See Brief, infra, page 37.

all expense in connection therewith borne by Honolulu, they were each furnished with the complete form of refund claim to be filed, and they were each furnished with the form required to enter into an agreement with the Commissioner to abide by the result of these cases. The distributions of capital taxed as income to the stockholders of Honolulu in the years 1936, 1937 and 1938 are equal to the loss realized by Honolulu upon the liquidation of its subsidiaries, namely, $1,225,908.63.

3. The Court below dismissed without consideration petitioner's alternative contention that section 501 of the Second Revenue Act of 1940 is unconstitutional as applied to the facts of this case, basing said failure to consider on the ground that petitioner failed to prove that the loss on the liquidation of the subsidiaries was incurred in 1936. This fact was stipulated. Petition for rehearing was based on this ground, amongst others, and was denied.

Wherefore, it is respectfully submitted that this petition for writ of certiorari to review the judgment of the Circuit Court of Appeals for the Ninth Circuit should be granted.

Dated, San Francisco, California,
May 16, 1945.

Leon de Fremery,
*Attorney for Petitioner.*

## Certificate of Counsel.

I hereby certify that I am attorney for petitioner herein and that in my judgment the foregoing petition for a writ of certiorari is well founded and that it is not interposed for delay.

Dated, San Francisco, California,
May 16, 1945.

Leon de Fremery,
*Attorney for Petitioner.*

# In the Supreme Court
OF THE
# United States

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October Term, 1944

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No.

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| Lorin A. Cranson, | *Petitioner,* |
| vs. | |
| The United States of America, | *Respondent.* |

## BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

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### JURISDICTION OF THE CASE.

This petition is filed to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered January 24, 1945 (R. 75), rehearing denied February 26, 1945 (R. 76), which affirmed the judgment of the United States District Court for the Northern District of California, Southern Division, entered October 25, 1943. (R. 62.) No opinion was filed by the District Court. The opinion of the Circuit Court of Appeals was filed January 24, 1945, is re-

ported at 146 F. (2d) 871, and a copy will be found in the printed Transcript of Record at pages 71 to 74.

The jurisdiction of this Court is invoked under section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925. (Appendix, p. i.)

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## STATEMENT OF THE CASE.

A summary statement of the case, including the essential facts, is set forth in the foregoing petition at pages 2 to 6.

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## SPECIFICATION OF ERRORS.

With respect to petitioner's principal contention, the Court below erred as follows:

1. In deciding that the operating deficits of the subsidiary corporations of Honolulu as of the date of their liquidation in 1936 did not diminish the earnings or profits of Honolulu which were otherwise available for dividends.

2. In assuming that it was necessary for petitioner to prove what portion of the deficits of the subsidiaries occurred in the tax year 1936.

With respect to petitioner's alternative contention that the loss actually realized by Honolulu on the liquidation of its subsidiaries in 1936 reduced the earnings of Honolulu available for dividends, the Court below erred as follows:

1. In dismissing said alternative contention without consideration on the ground that there was no showing that any of said loss was incurred in the tax year 1936. It is stipulated that the subsidiaries were liquidated on August 31, 1936, and that upon said liquidation Honolulu realized a loss of $1,225,908.63, the entire amount of the loss in question. (R. 33.)

2. In stating that it is admitted that $931,553.82 earnings or profits were made in 1936 by Honolulu. It is stipulated that these are the earnings before deducting the loss of $1,225,908.63 realized in 1936 upon the liquidation of the subsidiaries. (R. 38.)

3. In failing to determine that section 501 of the Second Revenue Act of 1940, insofar as its application to the facts of this case is concerned, violates the provisions of the Sixteenth Amendment to the Constitution of the United States and the due process clause of the Fifth Amendment to the Constitution of the United States.

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## SUMMARY OF ARGUMENT.

I. The operating deficits of said subsidiaries were inherited by Honolulu upon the nontaxable liquidation of said subsidiaries.

(a) The principle established by *Commissioner v. Sansome,* 60 F. (2d) 931 (C.C.A. 2), certiorari denied, 287 U. S. 667, and succeeding cases is that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture, with the result that under the doctrine of

these cases it is held that the earnings or profits of the transferor corporation are transferred intact to the successor or transferee corporation.

(b) Under the doctrine of the *Sansome* case that the continuity of the corporate life as a continuing venture is not broken, no valid distinction can be drawn between operating deficits on the one hand and earnings or profits on the other hand.

(c) Section 501 of the Second Revenue Act of 1940, and the Treasury Regulations expressing the same principles prior to the enactment of this section, will not operate in an equitable manner insofar as nontaxable liquidations of subsidiary corporations are concerned unless the Sansome doctrine applies to operating deficits as well as to earnings.

(d) The Court below erred in assuming that it was necessary for petitioner to prove what portion of the deficits of the subsidiaries occurred in the tax year 1936.

II. If it is held that the operating deficits of said subsidiaries were not inherited by Honolulu, then it is contended in the alternative that the loss realized by Honolulu upon the liquidation of said subsidiaries reduced the earnings of Honolulu available for dividends.

(a) Section 501 of the Second Revenue Act of 1940 in its application to the facts of this case violates the provisions of the Sixteenth Amendment to the Constitution of the United States.

(b) The attempted retroactive application of section 501 of the Second Revenue Act of 1940 violates the due process clause of the Fifth Amendment to the Constitution of the United States.

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## ARGUMENT.

### I.

### THE OPERATING DEFICITS OF SAID SUBSIDIARIES WERE INHERITED BY HONOLULU UPON THE NONTAXABLE LIQUIDATION OF SAID SUBSIDIARIES.

The question involved in this petition is the extent to which the stockholders of Honolulu must report as subject to federal income tax certain distributions paid by Honolulu to its stockholders during the calendar year 1936.

The gross income which is subject to the income tax, after the allowance of certain statutory deductions, is defined by section 22(a) of the Revenue Act of 1936 (Appendix, pp. i and ii) (the statute controlling the decision of this petition) to include dividends, and the term dividends is defined by section 115(a) of the Act (Appendix, pp. v and vi) as a distribution out of the "earnings or profits" of a corporation, whether those of the taxable year or those accumulated since March 1, 1913. If a corporation declares dividends out of its earnings or profits, such dividends constitute income to the stockholders upon which they must pay taxes. On the other hand, if the corporation has no earnings or profits available for dividends, or if its dividends exceed the earnings or profits which are available, then

to the extent that the dividends are not paid out of earnings or profits of the corporation such distributions do not constitute income to the stockholders and are received free from tax until such time as the tax-free distributions received exceed the cost of the stock to the stockholders.

**(a) The principle established by the Sansome case and succeeding cases is that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture, with the result that under the doctrine of these cases it is held that the earnings or profits of the transferor corporation are transferred intact to the successor or transferee corporation.**

Since the term "earnings or profits" is not defined by the statute, problems have arisen regarding the interpretation to be given this term. One of the earliest situations requiring judicial construction was that arising in connection with the tax-free transfer of the assets and business of one corporation to another corporation. In 1921 a New Jersey corporation transferred all its assets to a new corporation, which assumed the liabilities of the old corporation and issued its shares to the shareholders of the old corporation. Prior to its reincorporation the old corporation had a large earned surplus available for dividends, and if this corporation had paid dividends the stockholders would obviously have paid taxes thereon. After the reincorporation the new corporation paid dividends to its stockholders, who were identically the same persons as the stockholders of the old corporation, and these stockholders contended that the dividends were tax-free, since the new corporation had no earnings of

its own available for dividends. The question thus presented came up for decision in the Circuit Court of Appeals for the Second Circuit in *Commissioner v. Sansome*, 60 F. (2d) 931 (1932), certiorari denied, 287 U. S. 667. That Court, in an opinion by Judge Learned Hand, held that the new corporation had *acquired the earnings of the old corporation* and the dividends were therefore subject to tax. The Court stated that the reincorporation was a nontaxable corporate reorganization under the express provisions of the statute making such reorganizations nontaxable, and came to the conclusion that nontaxable reorganizations do not break the continuity of the corporate life, saying:

> "Hence we hold that a corporate reorganization which results in no 'gain or loss' under Section 202(c)(2) (42 Stat. 230)" (the reorganization section of the statute) *"does not toll the company's life as a continued venture* under Section 201," (the dividend section of the statute) "and that *what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation."* (Italics added.)

*Commissioner v. Sansome* is the leading case on the subject of the transfer of corporate earnings from one corporation to another corporation in a nontaxable reorganization, the principle established by that case being known as the Sansome Rule.

The principle that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture applies to consolidations of two or more corporations. In *Baker v. Commissioner*, 80 F.

(2d) 813 (C.C.A. 2, 1936), where a parent corporation consolidated five wholly owned subsidiaries into a new company, it was held that the earnings of the five subsidiaries were transferred intact to the successor corporation.

Many cases could be cited in support of this principle, but no purpose would be served in multiplying citations since there are no cases to the contrary,[5] and the Sansome Rule is now recognized as an established principle of income tax law. The principal cases are cited in par. 9.58 of Mertens' twelve-volume work on the Law of Federal Income Taxation. With respect to liquidations, Mertens states (Vol. I, pp. 507-8):

> "In a tax-free liquidation of a subsidiary into a parent corporation, the earnings or profits of the former are not considered distributed but simply transferred intact to the parent. The theory of continued identity of earnings obtains also where there is more than one transferor."

The tax-free liquidation of a subsidiary into a parent corporation was first permitted under the Revenue Act of 1936, which added subsection (6) to section 112(b) of the statute as it existed prior thereto.[6] The pertinent portion of this subsection reads as follows:

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[5]See, however, *Campbell v. U. S.*, 144 F. (2d) 177 (C.C.A. 3, 1944), holding the doctrine of the *Sansome* case inapplicable because of lack of continuity of proprietary interests, although the decision is also based on the ground that all earnings were distributed in cash as a part of the reorganization.

[6]Section 110(a) of the Act of 1935 (49 Stat. 1020) made a similar amendment to the 1934 Act, but this amendment was never actually effective, since it was applicable only to taxable years beginning after December 31, 1935, and was superseded by the Revenue Act of 1936.

"(6) **Property received by a corporation on complete liquidation of another.**—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation." (Set forth in full, Appendix, pp. ii-iv.)

Section 112(b)(6) as thus enacted continued in the same form in the Revenue Act of 1938 and thereafter in the Internal Revenue Code.

After the Sansome Rule became recognized as an established principle of income tax law, the Treasury Regulations were amended to incorporate this principle. Regulations 94, issued under the Revenue Act of 1936, contains the following provision:

"Art. 115-11. **Effect on earnings or profits on (of) certain tax-free exchanges and tax-free distributions.**—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization *or a complete liquidation under section 112(b)(6)* * * *), gain or loss was not recognized * * *, then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations." (Italics added.) (Set forth in full, Appendix, pp. ix-xi.)

The foregoing regulation applies by its terms to transactions other than the complete liquidation of a subsidiary corporation, but with respect to the complete liquidation of a subsidiary corporation, which of course necessarily results in the dissolution of the

subsidiary, it is obvious that the only "proper adjustment and allocation of the earnings or profits of the transferor" which can be made as between the transferor and transferee corporations is the transfer of all the earnings or profits of the subsidiary to the parent corporation. In this respect the regulation is but a recognition of the general principle referred to above as having been established by the cases, namely, that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture.

The quoted portion of Article 115-11 of Regulations 94 was continued without change in Regulations 101 relating to the Revenue Act of 1938 and Regulations 103 relating to the Internal Revenue Code. However, the following addition to Article 115-11 was made in 1938 by Regulations 101, and appeared immediately following the portion quoted above:

> "The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:
>
> (1) * * *
>
> (2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation *in complete liquidation of another corporation,* under the circumstances described in section 112(b) (6) of the Revenue Act of 1936 or section 112 (b) (6) of the Revenue Act of 1938.
>
> (3) * * *
>
> (4) * * *

A distribution described in paragraphs (1), *(2)*, (3) or (4) above does not diminish the earnings or profits of any corporation. In such cases, *the earnings or profits remain intact and available for distribution as dividends* by the corporation making such distribution, or *by another corporation to which the earnings or profits are transferred* upon such reorganization or other exchange." (Italics added.) (Set forth in full, Appendix, pp. xiii-xvi.)

The addition thus made to the regulations in 1938 is merely a clarification of the portion of the regulation heretofore quoted (supra, p. 21) as it existed in 1936 and as continued in 1938. The portion of the regulation heretofore quoted could only mean, as applied to the complete liquidation of a subsidiary corporation, that the earnings or profits of the subsidiary would be transferred to the parent corporation. The addition made in 1938, quoted above, is more specific, and, as applied to the facts of our case, after stating that the distribution in liquidation by the three subsidiary corporations of Honolulu does not diminish the earnings or profits of the subsidiaries, continues with the statement that the earnings or profits remain intact and available for distribution as dividends by the corporation to which the earnings or profits are transferred, namely, Honolulu.

The addition to the regulations thus made in 1938 was continued without change in Regulations 103 as issued under the Internal Revenue Code.

Thus ever since the Revenue Acts have permitted the tax-free liquidation of subsidiaries, beginning with

the year 1936, the regulations have provided that the earnings or profits of the subsidiaries remain intact and are transferred to the parent corporation. At the same time the regulations also contained the following provision:

> "Gains and losses within the purview of section 112 or corresponding provisions of prior Acts *are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.*" (Italics added.)[7]
>
> (See Article 115-3 of Regulations 94 and 101 and Section 19.115-3 of Regulations 103, Appendix, pp. ix-xi.)

Section 112 of the Revenue Act of 1936 referred to in this regulation permits certain transactions, including the liquidation of subsidiary corporations, to be consummated without incurring income tax. This provision of the regulations is a companion provision to the provision referred to above (Article 115-11), and is part of the same general plan adopted by the regulations to synchronize the effect of tax-free reorganizations upon *earnings or profits* available for dividends, as distinguished from taxable net income. As applied to the liquidation of subsidiaries, for example, if a subsidiary had an earned surplus and its liquidation resulted in a profit to the parent, it is obvious that the earned surplus of the parent should not be increased by *both* the earned surplus of the subsidiary and the profit which is actually *realized* by the

[7]This is the regulation approved by this Court in *Commissioner v. Wheeler*, ........ U.S. ........, decided March 26, 1945.

parent, although not *recognized* for tax purposes.[8] Thus the regulations provide that the earned surplus will be transferred, but on the other hand realized profit (not recognized under section 112 as subject to tax) will not be taken into account in the computation of earnings or profits available for dividends.

What is the result if the subsidiary has an operating deficit and its liquidation results in a loss to the parent corporation?

**(b) Under the doctrine of the Sansome case, that the continuity of the corporate life as a continuing venture is not broken, no valid distinction can be drawn between operating deficits on the one hand and earnings or profits on the other hand.**

Before discussing the effect of an operating deficit in the transferor corporation, the meaning of the terms "earnings available for dividends" and "operating deficit" must be clearly understood. A corporation has earnings available for dividends if its profits, after deducting dividends declared out of profits, exceed its losses. In such case the balance of its earned surplus account will appear on the right-hand or credit side. Since the earned surplus account normally appears on the right-hand or liability side of the balance sheet, together with capital stock, paid-in surplus, and other "net worth" accounts, an earned surplus account with a balance on the right or credit side would be said to have a positive rather than a negative balance. On the other hand, a corporation has an operating deficit if its operating losses exceed its profits. In this case the balance in its earned surplus

[8]See the examples under section I (c) of the Brief, infra, pages 38 to 44.

account will appear on the left-hand or debit side. Such a balance would be said to be a negative balance in the earned surplus account.

It will perhaps be helpful to illustrate the foregoing by the following simple examples:

Assume that X Company had earnings available for dividends on January 1, 1936, in the amount of $200,000, that its profits for 1936 were $50,000, and that it declared two $10,000 dividends during the year. Its earned surplus account would then appear as follows:

X Company

Earned Surplus

| | | | | | |
|---|---|---|---|---|---|
| 1936 | | | 1936 | | |
| June 1 | Dividend | 10,000 | Jan. 1 | Balance | 200,000 |
| Dec. 1 | Dividend | 10,000 | Dec. 31 | Profits, 1936 | 50,000 |
| Dec. 31 | Balance | 230,000 | | | |
| | | 250,000 | | | 250,000 |
| | | | 1937 | | |
| | | | Jan. 1 | Balance | 230,000 |

On the other hand, assume that Y Company had an operating deficit on January 1, 1936, in the amount of $100,000, and that its earnings for 1936 were $60,000. Its earned surplus account would then appear as follows:

Y Company

Earned Surplus

| | | | | | |
|---|---|---|---|---|---|
| 1936 | | | 1936 | | |
| Jan. 1 | Balance | 100,000 | Dec. 31 | Profits, 1936 | 60,000 |
| | | | Dec. 31 | Balance | 40,000 |
| | | 100,000 | | | 100,000 |
| 1937 | | | | | |
| Jan. 1 | Balance | 40,000 | | | |

It will be seen that the balance of the earned surplus account of Y Company on January 1, 1936, appeared on the left-hand or debit side, indicating that it had no earned surplus but on the contrary an operating deficit in the amount of $100,000. It thus had a negative balance in its earned surplus account. It will also be seen that the profits for 1936 in the amount of $60,000 operated to reduce this negative balance or operating deficit to the amount of $40,000, the balance appearing on January 1, 1937. An operating deficit must be eliminated by subsequent earnings before there can be accumulated earnings or profits available for dividends (except that dividends may be paid from the current earnings of the taxable year). All the cases recognize this principle as basic. See for example, *Commissioner v. W. S. Farish & Co.*, 104 F. (2d) 833 (C.C.A. 5, 1939). Therefore an operating deficit cannot be disregarded or charged to some other account, but must be carried in the *earned surplus* account, in order that the books will clearly indicate at what point subsequent profits have eliminated this adverse

balance, after which additional profits will constitute earnings available for dividends.

To complete the picture we will assume that the following two balance sheets represent the condition of X Company and Y Company on January 1, 1936:

X Company

Balance Sheet, January 1, 1936

| Assets | | Liabilities | |
|---|---|---|---|
| Cash | 5,000 | Earned Surplus | 200,000 |
| Real Estate & Plant | 1,495,000 | Capital Stock | 1,300,000 |
| | 1,500,000 | | 1,500,000 |

Y Company

Balance Sheet, January 1, 1936

| Assets | | Liabilities | |
|---|---|---|---|
| Cash | 5,000 | Earned Surplus | 100,000 |
| Real Estate & Plant | 1,195,000 | Capital Stock | 1,300,000 |
| | 1,200,000 | | 1,200,000 |

It will be seen that the earned surplus of X Company appears in the foregoing balance sheet as a positive or black figure, whereas the earned surplus of Y Company appears as a negative or red figure. As has been heretofore stated, under the doctrine of the *Sansome* case as set forth in numerous judicial decisions and as incorporated in the Treasury regulations, it is clear that upon the liquidation of a subsidiary corporation its earnings or profits are transferred to the parent corporation. Can any dis-

tinction be drawn between earnings and profits which, as we have seen, represent a positive balance in the earned surplus account, and an operating deficit, which is a negative balance in the earned surplus account?

In the present case the three wholly owned subsidiaries of Honolulu had total operating deficits in the amount of $1,205,451.61, and Honolulu realized a loss upon the liquidation of these subsidiaries in the amount of $1,225,908.63 (the slight difference in these figures is explained in Footnote No. 1 on page 5 of the preceding petition). It is apparent that the earned surplus of Honolulu should not be reduced by both the loss which it realized upon the dissolution of these subsidiaries and the total operating deficits of the subsidiaries, since this would be a duplication of the same loss. It is also apparent that in order to avoid a substantial overstatement of the earned surplus of Honolulu it is necessary to reduce its earned surplus either by the loss realized or by the operating deficits of the subsidiaries.

Article 115-3 of the regulations (supra, p. 24) specifically refers to losses as well as gains, and provides that the loss realized by Honolulu will not reduce the earnings and profits of Honolulu because it was not recognized for tax purposes under section 112. On the other hand, the companion provision of the regulations, namely, Article 115-11 (supra, pp. 21-23), refers only to the transfer of the earnings or profits and not to the transfer of an operating deficit. These two articles, being part of the same general

plan to synchronize the effect of tax-free reorganizations upon earnings or profits available for dividends, must be read together. In view of the fact that Article 115-3 refers to losses as well as gains, it is quite possible that Article 115-11 should be interpreted to include operating deficits within the meaning of the words "earnings or profits". As we have seen, an operating deficit is but a negative balance in the earned surplus account, and such an interpretation would not be unreasonable.

We are merely suggesting but not insisting upon such an interpretation, since it is possible that the Treasury Department did not intend to go beyond the decided cases in promulgating this regulation. When the regulations first incorporated a provision relating to the transfer of earnings from one corporation to another in a nontaxable reorganization, which, as we have heretofore seen, occurred in 1936, the doctrine of the *Sansome* case had already become firmly established. The doctrine was recognized and discussed in Paul and Mertens' authoritative work on the Law of Federal Income Taxation (par. 8.45), which was published in 1934, but the doctrine of the *Sansome* case was not incorporated in Regulations 86, which appeared in 1935, and it was not until Regulations 94 were adopted in 1936 that this doctrine made its appearance in the provisions of Article 115-11 to which we have referred above. Thus the regulations merely followed the decided cases, which have dealt only with transferor corporations having earnings. None of the cases thus far decided has dealt with an operating deficit, and it is possible, therefore, that

the Treasury Department is waiting for decisions on this subject before expanding its regulations to definitely include operating deficits as well as earnings.

Since the principle upon which the transfer of earnings in a tax-free reorganization is based is that the *continuity of the corporate life as a continuing venture is not broken,* it is obvious that no logical distinction can be drawn between earnings and operating deficits. There is no magic in the figure being black rather than red. Suppose, for example, that X Company and Y Company, whose earned surplus accounts have been set forth above (pp. 26 and 27), were to reorganize by means of a nontaxable statutory merger. If in such case Y Company was the continuing corporation and therefore did not cease to exist, its operating deficit in the amount of $100,000 would obviously not disappear but would continue on its books. On the other hand, the earnings of X Company in the amount of $200,000 would be transferred intact to Y Company in accordance with the Sansome Rule. Thus the earned surplus of the combined companies after the merger would show earnings available for dividends in the amount of $100,000, which would consist of the earnings of X Company less the operating deficit of Y Company.

If, on the other hand, X Company was the continuing corporation, then its surplus of $200,000 would of course continue on its books. But the parties to this proceeding differ as to the treatment to be accorded the operating deficit of Y Company. It is petitioner's contention that, in accordance with the

principle of the Sansome Rule that the continuity of the life of Y Company as a continuing venture is not broken, the operating deficit of Y Company would be transferred to X Company, thus reducing the earnings available for dividends of the combined corporations to $100,000, and producing the same result as though Y Company had been the continuing corporation. On the other hand, the Government, in attempting to make a distinction between operating deficits and earnings or profits, would contend that the operating deficit of Y Company would *not* be transferred to X Company in the merger, with the result that the combined corporations would have earnings of $200,000 available for dividends. Thus the Government is forced into the position of contending *that a different result obtains, depending upon whether X Company or Y Company is the continuing corporation.* The results of tax-free mergers should certainly not depend upon such insubstantial differences.

Taking an illustration more closely paralleling the facts of the instant case, let us suppose one of the wholly owned subsidiaries of Honolulu had had earnings of $1,000,000 and the remaining two subsidiaries had total operating deficits of $2,205,451.61, making a net operating deficit for the three subsidiaries of $1,205,451.61, which is the actual total operating deficit of the three wholly owned subsidiaries that were liquidated. In such case Honolulu would have sustained the same loss on the liquidation of the three subsidiaries as it actually sustained upon the liquidation of its three wholly owned subsidiaries in 1936, and this

loss would have been substantially the same as the net operating deficits of the three subsidiaries in the total amount of $1,205,451.61. However, the Government, in accordance with the distinction that it attempts to make, would transfer the earned surplus of one of the subsidiaries, in the total amount of $1,000-000, but would refuse to permit the transfer of the operating deficits of the two other subsidiaries, in the amount of $2,205,451.61. Thus the earnings of Honolulu available for dividends would be *increased* by the amount of $1,000,000, whereas they should actually be *decreased* by the amount of $1,205,451.61. Not only is this result completely erroneous, but it is entirely illogical as well.

The illogical results to which the Government is forced in the two foregoing illustrations could be avoided by simply recognizing that earnings and operating deficits are both balances of the same account —one positive, the other negative. The illogical results flow from the Government's insistence on splitting the account down the middle and insisting that balances on one side of the middle are to be treated differently from balances on the other side.

Mertens in his new work on the Law of Federal Income Taxation states (Vol. I, p. 510):

> "Although there are no cases in point, the conclusions expressed above (relating to the transfer of earnings) would seem, if correct, to apply to the absorption of deficits of predecessor corporations as well as of surplus."

In conclusion, on this phase of the argument, it is recognized that the application of the Sansome Rule to *all* cases of tax-free reorganizations may also lead to illogical results—but if so, the results will be equally illogical whether operating deficits or earnings are involved. In other words, the illogical nature of these results will not be caused by treating operating deficits in the same manner as earnings, but rather may result from the application of the Sansome Rule to all cases of tax-free reorganizations. Mertens in the work just cited recognizes this possibility, and suggests that the test as to whether earnings are transferred to the successor corporation should not be the "tax-free" character of the so-called reorganization, stating that (Vol. I, p. 510):

> "any such general test would confuse the issue and give rise occasionally to absurd results in the various types of situations arising under our complex exchange and reorganization provisions. The proper test is whether there is substantial identity of the several corporations and continuity of proprietary interests."

This theory of Mertens is commented upon merely for the purpose of pointing out that even under this narrower application of the Sansome Rule, not adopted in any of the decided cases,[9] the principle of the *Sansome* case would apply to the facts of the instant case. The three subsidiaries of Honolulu

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[9]Except that lack of continuity of proprietary interests was one of the grounds for the decision in *Campbell v. U. S.*, 144 F. (2d) 177. See Footnote 5, supra, page 20. Cf. *Robinette v. Commissioner*, ...... F. (2d) ...... (C.C.A. 9, March 19, 1945).

which were liquidated in 1936 were at all times wholly owned subsidiaries of Honolulu, and thus there was clearly "substantial identity of the several corporations and continuity of proprietary interests".

The argument that the operating deficits of these subsidiaries were absorbed by Honolulu applies, of course, with equal force to the acquistion by one of these subsidiaries, California Exploration Company, Inc., of the operating deficits of its two predecessors, also at all times wholly owned subsidiaries of Honolulu, which were carried forward on to the books of California Exploration Company, Inc. in the nontaxable consolidation which occurred in 1934. (See Petition herein, Summary Statement, supra, pp. 4 and 5.)

**(c) Section 501 of the Second Revenue Act of 1940, and the Treasury Regulations expressing the same principles prior to the enactment of this section, will not operate in an equitable manner insofar as nontaxable liquidations of subsidiary corporations are concerned unless the Sansome doctrine applies to operating deficits as well as to earnings.**

Ever since the issuance of Regulations 86 interpreting the Revenue Act of 1934, the Treasury Regulations have contained a sentence reading substantially the same as the following sentence from Article 115-1 of Regulations 86:

> "Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section." (Set forth in full, Appendix, pp. viii-ix.) (See corresponding Article 115-3 of later regulations, quoted supra, p. 24.)

The substance of these successive regulations was enacted as section 501 of the Second Revenue Act of 1940. This section of the statute added subsection (l) to section 115 of the Internal Revenue Code, the pertinent portion reading as follows:

> "* * * gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—
>
> (1) * * *
>
> (2) * * *
>
> * * * shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made." (Set forth in full, Appendix, pp. vi-viii.)

In *Commissioner v. Wheeler*, ...... U. S. ......, decided March 26, 1945, this Court held that the regulations which preceded the enactment of section 501 were a reasonable and valid exercise of the rule-making power. In so holding, the Court said:

> "Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income tax liability *but shall be taken account of later.* Sections 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits. Compare Commissioner v. Sansome, 60 F. (2d) 931, and see Sen. Rep. No. 2156, 74th Cong., 2d Sess. p.

19; H. R. Rep. No. 2894, 76th Cong., 3d Sess. p. 41. * * *" (Italics added.)

It is clear, therefore, that the basis of the decision in the *Wheeler* case is that recognition of gain or loss is deferred and that when taken account of for tax purposes at a later time, the effect upon earnings or profits available for dividends can at that time be likewise taken into account. But this is not true with respect to nontaxable liquidations of subsidiary corporations, where the recognition of gain or loss is *not* merely deferred—it is *never* entirely recognized for tax purposes,[10] and may, as in the instant case, receive no recognition whatever. This is so because the basis section of the statute (section 113(a)(15) of the Revenue Act of 1936 and of the Internal Revenue Code (Appendix, p. v)) provides that the basis of the property received by the parent from the subsidiary remains the same as it was in the hands of the subsidiary. This provision is necessary in order to prevent double taxation. On the subsequent sale of property acquired from the subsidiary the parent will pay a tax on all unrealized gains of the subsidiary (see A Co. immediately following), but no tax will be paid by the parent on the realized gains of the subsidiary on which the subsidiary has paid the tax. (See C Co. immediately following.)

The following simple examples will clearly show the effect of the basis section of the statute and section

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[10]This is true unless the subsidiary's operations have resulted in neither realized gain nor realized loss, as in the case of corporations A and X, infra, pages 39 and 42.

501 of the Second Revenue Act of 1940 upon the earnings or profits of a parent corporation on the liquidation of wholly owned subsidiary corporations, and the application in each example of the doctrine of the *Sansome* case.

We will first assume that the subsidiaries have been profitably operated. P Co., the parent, incorporates three subsidiaries, A Co., B Co., and C Co., invests $500,000 in each, and receives from each on liquidation assets of a value of $1,700,000. At liquidation A Co. has neither earnings nor operating deficit, B Co. has earnings of $400,000, and C Co. has earnings of $1,-200,000. Balance sheets at liquidation will thus be as follows:

A Co.

| | | | |
|---|---|---|---|
| Assets | $ 500,000 | Stock | $ 500,000 |
| | | Earned Surplus | $\phi$ |
| | $ 500,000 | | $ 500,000 |

B Co.

| | | | |
|---|---|---|---|
| Assets | $ 900,000 | Stock | $ 500,000 |
| | | Earned Surplus | 400,000 |
| | $ 900,000 | | $ 900,000 |

C Co.

| | | | |
|---|---|---|---|
| Assets | $1,700,000 | Stock | $ 500,000 |
| | | Earned Surplus | 1,200,000 |
| | $1,700,000 | | $1,700,000 |

**Explanatory Comments.**

**A Co.**

Since A Co. has neither earnings nor operating deficit, it follows that the increase in value of its assets from $500,000, the cost of the assets acquired with the original investment, to $1,700,000 has not been realized. Accordingly, the assets are still carried by A Co. at $500,000. Upon the liquidation, P Co. will realize a gain of $1,200,000 but this gain will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the increase of P Co.'s earnings by this realized gain. However, since the assets of A Co. retained their basis of $500,000 in the hands of P Co. (section 113(a)(15)), a gain of $1,200,000 will eventually be subjected to tax and will be reflected in P Co.'s earnings upon the sale of the assets for $1,700,000.[11] The correct result is reached without the application of the Sansome Rule.

**B Co.**

Since B Co. has earnings of $400,000, it follows that the book value of its assets has increased to $900,000. Since the assets are worth $1,700,000, the remaining $800,000 of the increase in value has not been realized by B Co. Upon the liquidation, P. Co. will realize a gain of $1,200,000 but this gain will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the increase of P Co.'s earnings

[11] If the assets are sold for more or less than $1,700,000 the result will still be correct, since the earnings of P Co. will then reflect an additional gain or loss realized while the assets are held by P Co.

by this realized gain. However, since the assets of B Co. retained their basis of $900,000 in the hands of P Co. (section 113(a)(15)), a gain of $800,000 will eventually be subjected to tax and be reflected in P Co.'s earnings upon the sale of the assets for $1,-700,000. The remaining $400,000 increase in P Co.'s earnings (upon which B Co. has paid a tax), which is required in order to equal the $1,200,000 gain realized on the liquidation is accomplished by the transfer of B Co.'s earnings to P Co. at the time of liquidation under the Sansome Rule. Thus the correct result is reached by a combination of the basis section and the Sansome Rule.

C Co.

Since C Co. has earnings of $1,200,000, it follows that the book value of its assets has increased to $1,700,000, which is their actual value. Thus the entire increase in value has been realized by C Co. and a tax paid thereon. Upon the liquidation, P Co. will realize a gain of $1,200,000, but this gain will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the increase of P Co.'s earnings by this realized gain. Furthermore, since the assets of C Co. retained their basis of $1,700,000 in the hands of P Co. (section 113(a)(15)), no portion of the gain of $1,200,000 will ever be reflected in P Co.'s earnings as a result of the subsequent sale of these assets. The entire $1,200,000 increase in P Co.'s earnings which is required in order to equal the $1,-200,000 gain realized on the liquidation is accomplished by the transfer of C Co.'s earnings to P Co.

at the time of liquidation under the Sansome Rule. Thus the correct result is reached by the application of the Sansome Rule alone.

It will thus be seen that where the subsidiaries have been profitably operated prior to their liquidation, the correct effect upon P Co.'s earnings is obtained under section 501 in all cases either by the operation of the basis section, or by the operation of the basis section in conjunction with the Sansome Rule, or by the operation of the Sansome Rule alone.

We will now assume that the subsidiaries have been operated at a loss. P Co., the parent, incorporates three subsidiaries, X Co., Y Co. and Z Co., invests \$1,700,000 in each, and receives from each on liquidation assets of a value of \$500,000. At liquidation X Co. has neither earnings nor operating deficit, Y Co. has an operating deficit of \$400,000, and Z Co. has an operating deficit of \$1,200,000. Balance sheets at liquidation will thus be as follows:

X Co.

| | | | |
|---|---|---|---|
| Assets | $1,700,000 | Stock | $1,700,000 |
| | | Earned Surplus | ϕ |
| | $1,700,000 | | $1,700,000 |

Y Co.

| | | | |
|---|---|---|---|
| Assets | $1,300,000 | Stock | $1,700,000 |
| | | Earned Surplus | 400,000 |
| | $1,300,000 | | $1,300,000 |

Z Co.

| | | | |
|---|---|---|---|
| Assets | $ 500,000 | Stock | $1,700,000 |
| | | Earned Surplus | 1,200,000 |
| | $ 500,000 | | $ 500,000 |

**Explanatory Comments.**

**X Co.**

Since X Co. has neither earnings nor operating deficit, it follows that the decrease in value of its assets from $1,700,000, the cost of the assets acquired with the original investment, to $500,000 has not been realized. Accordingly, the assets are still carried by X Co. at $1,700,000. Upon the liquidation, P Co. will realize a loss of $1,200,000, but this loss will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the decrease of P Co.'s earnings by this realized loss. However, since the assets of X Co. retained their basis of $1,700,000 in the hands of P Co. (section 113(a)(15)), a loss of $1,200,000 will eventually be recognized for tax purposes and be reflected in P Co.'s earnings on the sale

of the assets for ~~$1,700,000.~~ 500,000 The correct result is reached without the application of the Sansome Rule.

**Y Co.**

Since Y Co. has an operating deficit of $400,000, it follows that the book value of its assets has decreased to $1,300,000. Since the assets are worth $500,000, the remaining $800,000 of the decrease in value has not been realized by Y Co. Upon the liquidation, P Co. will realize a loss of $1,200,000 but this loss will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the decrease of P Co.'s earnings by this realized loss. However, since the assets of Y Co. retained their basis of $1,300,000 in the hands of P Co. (section 113(a)(15)), a loss of $800,000 will eventually be recognized for tax purposes and be reflected in P Co.'s earnings on the sale of the assets for $500,000. The remaining $400,000 decrease in P Co.'s earnings (taken by Y Co. for tax purposes) which is required in order to equal the $1,200,000 loss realized on the liquidation, can only be taken care of under the Sansome Rule, which should operate to transfer the $400,000 operating deficit of Y Co. to P Co. In such case the correct result will be reached by a combination of the basis section and the Sansome Rule.

**Z Co.**

Since Z Co. has an operating deficit of $1,200,000, it follows that the book value of its assets has decreased to $500,000, which is their actual value. Thus the entire decrease in value has been realized by Z Co.

and taken by it for tax purposes. Upon the liquidation, P Co. will realize a loss of $1,200,000, but this loss will not be recognized for tax purposes (section 112(b)(6)) and therefore section 501 prevents the decrease of P Co.'s earnings by this realized loss. Furthermore, since the assets of Z Co. retained their basis of $500,000 in the hands of P Co. (section 113(a)(15)) *no portion of the loss of $1,200,000 will ever be reflected in P Co.'s earnings* as the result of a subsequent sale of these assets. The entire $1,200,000 decrease in P Co.'s earnings which is required in order to equal the $1,200,000 loss realized on the liquidation can only be taken care of under the Sansome Rule, which should operate to transfer the $1,200,000 deficit of Z Co. to P Co. In such case the correct result will be reached by the Sansome Rule alone. The facts with respect to Z Co. are essentially the facts of this petition.

It is apparent from the foregoing examples, which cover every possible contingency with respect to the profitable or non-profitable operations of subsidiary corporations and their subsequent nontaxable liquidations, that section 501 of the Second Revenue Act of 1940 (adding section 115(l) to the Internal Revenue Code), taken in conjunction with section 113(a)(15) (the basis section) will in every case operate to produce the correct adjustment to the earnings or profits available for dividends of the parent corporation, if, and only if, the doctrine of the *Sansome* case is given full effect, including within the principle of that case operating deficits as well as earn-

ings. It is only to the extent that the gains or losses of the subsidiary have not been realized by the subsidiary, but are represented by appreciation or depreciation in the value of its assets, that the earnings of the parent will ultimately reflect the correct result. But in the great majority of cases where gains or losses have been realized by the subsidiary and are therefore reflected in its earned surplus account, the earnings of the parent which are available for dividends will never be correctly stated except through the application of the Sansome Rule, including therein operating deficits as well as earnings.

That Congress intended section 501 to operate in an equitable manner in all cases, and was of the opinion that it did so, is evident from the fact that by subsections (b) and (c) of section 501 (Appendix, p. viii) the amendment made to the Internal Revenue Code by this section was given retroactive effect as though it were a part of the Internal Revenue Code and of each of the prior Revenue Acts *for all taxable years.* Furthermore, it is clear that Congress was fully cognizant of the fact that section 501 was complementary to and must operate in conjunction with the doctrine of the *Sansome* case in order to produce the correct result. Thus in the report of the Senate Finance Committee (76th Congress, 3rd Session, Report No. 2114, p. 25) the Committee states:

> "Under various provisions of the Internal Revenue Code dealing with exchanges and *liquidations,* the transfer of the property by a corporation to another corporation results in the nonrecognition, in whole or in part, of the gain or

> loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. *These principles are to be given full effect under section 501.* The requirement of section 501 that there shall be no increase *or decrease* in earnings and profits by reason of a wholly unrecognized gain *or loss* is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee." (Italics added.)

The principle referred to in the foregoing quotation is, of course, the doctrine of the *Sansome* case, and it seems apparent that Congress expected the principle of that case to apply to both sides of the earnings and profits account—that is, to include a negative as well as a positive balance. Otherwise, how could it be said that the principle of that case is to be given full effect under the requirement of section 501 that there shall be *no decrease* in earnings and profits by reason of a wholly unrecognized *loss?* As we have seen, it is only by deciding that the principle of the *Sansome* case is applicable to operating deficits as well as to earnings that section 501 will operate in an equitable manner and produce the correct result in all cases.

**(d) The Court below erred in assuming that it was necessary for petitioner to prove what portion of the deficits of the subsidiaries occurred in the tax year 1936.**

The Court below makes the statement that:

> "It is apparent that appellant has not maintained its burden of proof that any of the deficits occurred in the tax year 1936 * * *. It is hence not before us to consider whether any such deficits would be deductible from the profits of the parent corporation if they had occurred in the tax year 1936."

The Court in its opinion gave no reason for believing it material to show what portion of the deficits of the subsidiaries occurred in 1936, but was apparently influenced by the Government's argument in its brief that the inheritance by Honolulu of the operating deficits of the subsidiaries in 1936 will not reduce Honolulu's earnings for 1936. This argument is based on the assumption that section 115(a) of the Act of 1936 would prevent such a reduction. This section of the statute reads in full as follows:

> "(a) **Definition of Dividend.**—The term 'dividend' when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), with-

> out regard to the amount of the earnings and profits at the time the distribution was made."

The portion of this section relied upon by the Government is that part defining a dividend to include any distribution "out of the earnings or profits of the taxable year". These words do not limit in any manner the *determination* of the earnings or profits of the taxable year, but merely state that any distribution therefrom constitutes a taxable dividend. It is obvious that the loss of $1,225,908.63 actually realized by Honolulu upon the liquidation of the subsidiaries occurred and could only occur at the moment the subsidiaries were liquidated on August 31, 1936, at which time Honolulu received all the assets of the subsidiaries in exchange for all the stock of the subsidiaries. Honolulu's earnings for 1936 available for dividends were actually eliminated by this loss. (R. 38.) Since the loss realized on this exchange exceeded Honolulu's earnings available for dividends, the *excess* became an operating deficit of Honolulu, *and a 1936 operating deficit.* If this Court should hold that the principle of the *Sansome* case applies not only to inherited earnings, but also to inherited operating deficits, then it is equally obvious that this inheritance occurs and can only occur at the moment of liquidation. At that moment the entire accumulated operating deficits of the subsidiaries in the amount of $1,205,451.61 would be inherited by Honolulu, with the result that the earnings available for dividends would be eliminated *in exactly the same manner as they actually were elimi-*

*nated* by the loss sustained. Since these accumulated operating deficits exceeded Honolulu's earnings available for dividends, the *excess*[12] would become an operating deficit of Honolulu at that moment, ***and necessarily a 1936 operating deficit of Honolulu.*** Not only is this the obvious result; it is the only result which does not have absurd consequences.

In order to demonstrate the fallacy of the Government's assumption that the operating deficits of the subsidiaries, *even though inherited by Honolulu,* do not reduce its earnings for 1936, let us assume for the moment that this assumption is correct. If the earnings for 1936 are not reduced, the only possible alternative is that the earnings of Honolulu for prior years in which the losses were sustained by the subsidiaries must be reduced, since otherwise there would be no reduction whatever and the operating deficits could not have been inherited by Honolulu. But taxes have been paid by the stockholders of Honolulu on these prior annual earnings without taking the annual operating deficits of the subsidiaries into account. The stockholders could not have avoided the payment of these taxes because to take the deficits of the subsidiaries into account would require a disregard of the separate corporate entities of the subsidiaries—a result which is not sup-

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[12]The operating deficits *of the subsidiaries* do not as such become operating deficits *of Honolulu*. It is important to note that it is only the *excess* of such deficits over Honolulu's earnings which becomes an operating deficit *of Honolulu*. Thus it is impossible to earmark the resulting deficit of Honolulu as traceable to any particular annual deficit of the subsidiaries.

ported by any authority. Thus the Government is arguing for the proposition that the stockholders must pay taxes on the annual dividends for prior years without taking into account the losses of the subsidiaries, and at the same time that the earnings for 1936 are not reduced by these losses when transferred to the parent corporation, so that the stockholders *never* receive the benefit of the reduction in earnings.

The error in the Government's assumption becomes even more apparent if it be assumed that the subsidiaries had earnings rather than operating deficits. Suppose, for example, that Honolulu had incorporated a subsidiary in 1936, and that this subsidiary had earnings of $100,000 a year for the years 1936, 1937, 1938 and 1939. Assume that Honolulu had an operating deficit in the amount of $500,000 at the beginning of 1936, had yearly earnings of $1,000,000, and declared dividends of $1,100,000, in each of these years. Since the dividends of Honolulu in each of these years exceeded its earnings by $100,000, it follows that for this period of four years the stockholders of Honolulu will have received total capital distributions in the amount of $400,000. Assume further that in January, 1940, the subsidiary, which has an earned surplus of $400,000, liquidates, and that Honolulu has earnings of $1,000,000 in 1940, not taking into account the earned surplus of the subsidiary in the amount of $400,000 which was transferred to Honolulu under the Sansome Rule. Honolulu then declares total dividends of $1,400,000 in 1940. It will be of assistance to tabulate the foregoing figures as follows:

| Year | HONOLULU Earnings | Dividends | Capital Distributions | SUBSIDIARY Earnings |
|---|---|---|---|---|
| 12/31/35 | $ *500,000* | | | |
| 1936 | 1,000,000 | $1,100,000 | $100,000 | $100,000 |
| 1937 | 1,000,000 | 1,100,000 | 100,000 | 100,000 |
| 1938 | 1,000,000 | 1,100,000 | 100,000 | 100,000 |
| 1939 | 1,000,000 | 1,100,000 | 100,000 | 100,000 |
| 1940 | 1,000,000 | 1,400,000 | | |

Since under the doctrine of the *Sansome* case the subsidiary's earnings in the amount of $400,000 had been transferred to Honolulu in 1940, it seems apparent that Honolulu's earnings for that year will be $1,400,000 and not $1,000,000 as the Government assumes. (This certainly would be the result if the subsidiary's earnings had been transferred by the declaration of a dividend immediately prior to liquidation.) But let us suppose for the moment that the Government is correct and that the transfer of the subsidiary's earnings did not increase Honolulu's earnings for 1940. In such case the stockholders of Honolulu, having received distributions of $1,400,000 in 1940, which according to the assumption exceeded the available earnings by $400,000, will have received further capital distributions in the amount of $400,000. Since they had previously received capital distributions for the years 1936 to 1939, inclusive, in the amount of $400,000, their total capital distributions would thus be $800,000. This is obviously erroneous, since Honolulu and its subsidiary combined earned during the five years 1936 to 1940, inclusive, a total of $5,400,000, and distributed to Honolulu's stockholders $5,800,000. Thus the total capital distributions are only $400,000. The Govern-

ment could not correct this erroneous result by going back to the years 1936 to 1939 and disallowing the capital distributions of $100,000 in each of these years (which incidentally might be barred by the statute of limitations), because to contend that the earnings of the subsidiary in the amount of $100,000 in each year were available for dividends by Honolulu disregards the separate corporate entities, which, as we have stated, is not supported by any authority.

It seems apparent, therefore, that the liquidation of a subsidiary and the transfer of its earnings to the parent corporation results in increasing the earnings of the parent corporation for the year in which the liquidation occurred. The transfer of an operating deficit would necessarily result in the same manner, that is, in the reduction of the earnings for the current taxable year. Thus earnings or operating deficits of the subsidiary for prior years are obviously not prior years' earnings or operating deficits *of the parent*, but upon transfer on the dissolution of the subsidiary become current earnings or operating deficits of the parent. As stated heretofore, all transactions necessarily affect the earnings of the year in which they occur. To hold otherwise in the case of the transfer of a subsidiary's earnings or operating deficits results in a disregard of the corporate entity, since the only possible alternative is to segregate the earnings and losses of the subsidiary into the respective years in which they occurred and assume a corresponding effect upon the earnings of the parent. Such a disregard of the separate corporate entities is not supported by any authority.

## II.

**IF IT IS HELD THAT THE OPERATING DEFICITS OF SAID SUBSIDIARIES WERE NOT INHERITED BY HONOLULU, THEN IT IS CONTENDED IN THE ALTERNATIVE THAT THE LOSS REALIZED BY HONOLULU UPON THE LIQUIDATION OF SAID SUBSIDIARIES REDUCED THE EARNINGS OF HONOLULU AVAILABLE FOR DIVIDENDS.**

**(a) Section 501 of the Second Revenue Act of 1940 in its application to the facts of this case violates the provisions of the Sixteenth Amendment to the Constitution of the United States.**

Honolulu sustained an admitted loss of $1,225,908.63 on the liquidation of its three wholly owned subsidiary corporations on August 31, 1936. This loss was sufficient to eliminate not only Honolulu's normal earnings for 1936 of $931,553.82, but also the earnings as of the beginning of the year of $139,631.26, with the result that the distributions made by Honolulu in 1936 were actually distributions of capital and not income to the recipient, except to the extent indicated in Footnote No. 2, supra, page 6 of the petition. To subject such distributions to the Federal income tax is clearly a violation of the Sixteenth Amendment to the Constitution of the United States. Although this contention was first specifically made in the Court below in the petition for rehearing, it was at all times argued, both in the District Court and in the Circuit Court of Appeals, that the distributions were actually distributions of capital and not income. The Courts below having held that petitioner must pay an income tax upon a return of capital, and having so held because of the provisions of section 501 of the Second Revenue Act of 1940, have necessarily decided that this statutory

provision is constitutional in its application to this particular situation. Whether the lower Court's application of this statute violates the provisions of the Sixteenth Amendment to the Constitution of the United States, insofar as petitioner and the other stockholders of Honolulu are concerned, is a matter necessarily involved in this case and therefore before this Court for decision.

**(b) The attempted retroactive application of section 501 of the Second Revenue Act of 1940 violates the due process clause of the Fifth Amendment to the Constitution of the United States.**

It has heretofore been conclusively shown (I(c) of this Brief, pp. 35 to 46) that section 501 of the Second Revenue Act of 1940 will not operate in an equitable manner insofar as nontaxable liquidations of subsidiary corporations are concerned unless the Sansome doctrine applies to operating deficits as well as to earnings. It has also been shown that Congress was fully cognizant of the fact that section 501 is complementary to and must operate in conjunction with the doctrine of the *Sansome* case in order to produce the correct result. (Supra, p. 45.) Furthermore, it seems clear that Congress was of the opinion that section 501 produces the correct result in all cases; otherwise it would hardly have provided that the amendment should operate retroactively *for all taxable years.* As has been shown, it is only by deciding that the principle of the *Sansome* case is applicable to operating deficits as well as to earnings that section 501 will operate in an equitable manner, and in such case there

can be no objection to its retroactive application. But if it is to be held that the Sansome Rule is limited to the inheritance of earnings and does not apply to the inheritance of an operating deficit, then it is contended that the retroactive application of the amendment made by section 501(a) of the Second Revenue Act of 1940, as provided by section 501(c), to a transaction occurring more than four years prior thereto, is confiscatory and invalid and a violation of the due process clause of the Fifth Amendment to the Constitution of the United States.

It is recognized that retroactive income taxes have been sustained as constitutional where their retroactivity is limited to the taxable year in which the statute is passed, or even to the preceding year already closed. Thus in *United States v. Hudson*, 299 U. S. 498 (1937), this Court said:

> "As respects income tax statutes, it long has been the practice of Congress to make them retroactive for relatively short periods so as to include profits from transactions consummated while the statute was in process of enactment, or within so much of the calender year as preceded the enactment; and repeated decisions of this Court have recognized this practice and sustained it as consistent with the due process of law clause of the Constitution."

And in *White Packing Company v. Robertson*, 89 F. (2d) 775 (C.C.A. 4, 1937), it was held that the Act of Congress approved June 22, 1936, imposing the so-called "windfall tax", was valid, although applying

to income received during the taxable year 1935, so as to be retroactive for a maximum period of about sixteen months.

In *Welch v. Henry*, 305 U. S. 134 (1938), a Wisconsin statute enacted in 1935 was upheld as constitutional, although it was given retroactive effect to 1933. After referring to the cases upholding income tax statutes given retroactive effect for the year of the session in which the taxing statute is enacted, and in some instances during the year of the preceding session, this Court upheld the Wisconsin statute on the ground that the regular session of the Wisconsin Legislature which preceded the enactment of the statute was the 1933 session. This Court said:

> "And we think that the 'recent transactions' to which this Court has declared a tax law may be retroactively applied, Cooper v. United States, 280 U. S. 409, 411, 50 S. Ct. 164, 74 L. Ed. 516, must be taken to include the receipt of income *during the year of the legislative session preceding that of its enactment.* (Italics added.)
>
> * * * * * * *
>
> While the Supreme Court of Wisconsin, 223 Wis. 319, 271 N. W. 68, 72, thought that the present tax might 'approach or reach the limit of permissible retroactivity', we cannot say that it exceeds it."

In view of the foregoing authorities it would seem that section 501(b) of the Second Revenue Act of 1940, making the amendment to the Internal Revenue Code contained in section 501(a) retroactive for the

effective period of the Code, that is to say, to January 1, 1939, covers a period which is "recent" and is therefore a proper exercise of the legislative power. With respect to section 501(c), however, which purports to make the amendment operative *for all prior years,* if it should be held that the operating deficits of its subsidiaries were not transferred to Honolulu, then it is contended that a serious inequity results and that section 501(c) is confiscatory in so far as this appellant is concerned, and in violation of the due process clause of the Constitution.

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## CONCLUSION.

The doctrine of the *Sansome* case is peculiarly applicable to the nontaxable liquidation of the three wholly owned subsidiaries of Honolulu because they meet the suggested narrower test of substantial identity of the several corporations and continuity of proprietary interests.

It is of general importance in the administration of the revenue laws that this Court should determine whether the principle of the *Sansome* case is applicable so as to transfer an operating deficit on the nontaxable liquidation of a subsidiary corporation, or whether in the case of such liquidations the regulation approved in *Commissioner v. Wheeler,* ...... U. S. ...... (March 26, 1945), is unreasonable and invalid and section 501 of the Second Revenue Act of 1940 unconstitutional.

Wherefore, it is respectfully submitted that a writ of certiorari should issue as prayed for in the petition herein.

Dated, San Francisco, California,
May 16, 1945.

LEON DE FREMERY,
*Attorney for Petitioner.*

**(Appendix Follows.)**

## Index to Appendix

## Appendix

### STATUTORY PROVISIONS.

**Judicial Code, Section 240(a) as amended by Act of February 13, 1925, 43 Stat. 938, 28 U.S.C.A., Section 347.**

(a) In any case, civil or criminal, in a circuit court of appeals, or in the Court of Appeals of the District of Columbia, it shall be competent for the Supreme Court of the United States, upon the petition of any party thereto, whether Government or other litigant, to require by certiorari, either before or after a judgment or decree by such lower court, that the cause be certified to the Supreme Court for determination by it with the same power and authority, and with like effect, as if the cause had been brought there by unrestricted writ of error or appeal.

**Revenue Act of 1936, Section 22(a) (49 Stat. 1657).**

(a) General Definition.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shal! be included in gross

income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

**Revenue Act of 1936, Section 112(b)(6) (49 Stat. 1679).**

(6) Property Received by Corporation on Complete Liquidation of Another.—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. For the purposes of this paragraph a distribution shall be considered to be in complete liquidation only if—

(A) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 per centum of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), and was at no time on or after the date of the adoption of the plan of liquidation and until the receipt of the property the owner of a greater percentage of any class of stock than the percentage of such class owned at the time of the receipt of the property; and

(B) no distribution under the liquidation was made before the first day of the first taxable year of the corporation beginning after December 31, 1935; and either

(C) the distribution is by such other corporation in complete cancellation or redemption of

all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the stockholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock, shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(D) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

If such transfer of all the property does not occur within the taxable year the Commissioner may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such three-year period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, the assessment and collection of all income,

war-profits, and excess-profits taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this paragraph shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for the purposes of this paragraph a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (i) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, upon an exchange described in paragraph (4) of this subsection, and (ii) the complete cancellation or redemption under the plan, as a result of exchanges described in paragraph (3) of this subsection, of the shares not owned by the taxpayer.

**Revenue Act of 1936, Section 112(g) (49 Stat. 1691).**

(g) DEFINITION OF REORGANIZATION.—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80

per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

**Revenue Act of 1936, Section 113(a)(15) (49 Stat. 1684).**

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

(15) Property Received by a Corporation on Complete Liquidation of Another.—If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112(b)(6), then the basis shall be the same as it would be in the hands of the transferor.

**Revenue Act of 1936, Section 115(a) (49 Stat. 1687).**

(a) Definition of Dividend.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insur-

ance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

**Second Revenue Act of 1940, Section 501 (54 Stat. 1004).**

Sec. 501. Earnings and Profits of Corporations.

(a) Under Internal Revenue Code.—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-free Distributions.—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall

be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

"(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

"(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

"(m) EARNINGS AND PROFITS—INCREASE IN VALUE ACCRUED BEFORE MARCH 1, 1913. (This subsection omitted as not material.)"

(b) EFFECTIVE DATE OF AMENDMENT.—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) UNDER PRIOR ACTS.—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

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## REGULATIONS.

**Regulations 86, Article 115-1 (Revenue Act of 1934).**

Art. 115-1. **Dividends.**—The term "dividends" for the purpose of Title I (except when used in sections 203 (a) (4) and 207 (c) (1)) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. Among the items entering into the computation of corporate "earnings or profits" for a particular period are all income exempted by statute, income not

taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section. Although interest on State bonds and certain other obligations is not taxable when received by a corporation, when distributed to shareholders in dividends is taxable to the same extent as other dividends.

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. (See article 42-3.)

**Regulations 94, Article 115-3 (Revenue Act of 1936).**

**Regulations 101, Article 115-3 (Revenue Act of 1938).**

**Regulations 103, Section 19.115-3 (Internal Revenue Code).**

Art. 115-3. **Earnings or profits.**—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income

under section 22(a) of the Act or corresponding provisions of prior Acts.* Gains and losses within the purview of section 112 or corresponding provisions of prior Acts* are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

In the case of a corporation in which depletion is a factor in the determination of income, the only depletion deductions to be considered in the computation of earnings or profits are those based on (1) cost or other basis, if the depletable asset was acquired subsequent to February 28, 1913, or (2) adjusted cost or March 1, 1913, value, whichever is higher, if acquired prior to March 1, 1913. Thus, discovery and percentage depletion under all Revenue Acts for mines and oil and gas wells should not be taken into consideration in computing the earnings or profits of a corporation.

A loss sustained for a year prior to the taxable year does not affect the earnings or profits of the taxable year. However, in determining the earnings or profits accumulated since February 28, 1913, the excess of a loss sustained for a year subsequent to February 28, 1913, over the undistributed earnings or profits accumulated since February 28, 1913, and prior to the

*Section 19.115-3 of Regulations 103 reads "prior Revenue Acts".

year for which the loss was sustained, reduces surplus as of March 1, 1913, to the extent of such excess. And, if the surplus as of March 1, 1913, was sufficient to absorb such excess, distributions to shareholders after the year of the loss are out of earnings or profits accumulated since the year of the loss to the extent of such earnings.

With respect to the effect on the earnings or profits accumulated since February 28, 1913, of distributions made on or after January 1, 1916, and prior to August 6, 1917, out of earnings or profits accumulated prior to March 1, 1913, which distributions were specifically declared to be out of earnings or profits accumulated prior to March 1, 1913, see section 31(b) of the Revenue Act of 1916, as amended by section 1211 of the Revenue Act of 1917.

**Regulations 94, Article 115-11 (Revenue Act of 1936).**

Art. 115-11. **Effect on earnings or profits on certain tax-free exchanges and tax-free distributions.**— If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be

made as between the transferor and transferee corporations.

The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1936, or on or after such date) in exchange for its stock or securities (see section 112(b)(3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any

corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

For the purposes of this article, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932, and for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934.

**Regulations 101, Article 115-11 (Revenue Act of 1938).**

Art. 115-11. **Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.** If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in Section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year beginning before January 1, 1938, or on or after such date) in exchange for its stock or securities (see section 112(b)(3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation under the circumstances described in section 112(b)(6) of the Revenue Act of 1936 or section 112(b)(6) of the Revenue Act of 1938.

(3) The distribution in any taxable year (beginning after December 31, 1937) of stock or securities, or other property or money, in the case of an exchange or distribution described in sec-

tion 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purposes of this article, the terms "reorganization" and "party to the reorganization" shall,

for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; and for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936.

No. [redacted]

# In the Supreme Court of the United States

# INDEX



## CITATIONS

Cases:






650763—45——1

# In the Supreme Court of the United States

OCTOBER TERM, 1944

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No. 1305

LORIN A. CRANSON, PETITIONER

*v.*

UNITED STATES OF AMERICA

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT*

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**BRIEF FOR THE UNITED STATES IN OPPOSITION**

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## OPINION BELOW

The District Court rendered no opinion, and its findings (R. 60), incorporating the stipulated facts (R. 27–38), and conclusions of law (R. 61), are not reported. The opinion of the Circuit Court of Appeals (R. 71–74) is reported at 146 F. 2d 871.

## JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 24, 1945 (R. 75). A

petition for rehearing, filed by the taxpayer on February 20, 1945, was denied on February 26, 1945 (R. 76). The petition for a writ of certiorari was filed on May 23, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTION PRESENTED

Whether a cash distribution, received by the taxpayer during 1936, was paid out of the distributing corporation's earnings or profits and is consequently taxable as a dividend under Sections 22 (a) and 115 (a) of the Revenue Act of 1936.

The answer to this question depends on whether the corporation's earnings or profits were reduced either by a loss realized by the corporation upon the liquidation of three subsidiaries in 1936, or by the operating deficits of the subsidiaries existing at the date of the liquidation.

## STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are printed in the Appendix, *infra*, pp. 17–26.

## STATEMENT

The District Court found the facts as stipulated (R. 60). The material portions of the stipulation of facts (R. 27–59) may be summarized as follows:

Prior to August 31, 1936, Honolulu Oil Cor-

poration, Ltd. (hereinafter referred to as "Honolulu") owned all of the issued and outstanding stock of three subsidiary corporations, formed primarily for the purpose of acquiring and developing prospective oil properties and patents relating to the processing of crude petroleum (R. 31–33). On August 31, 1936, the three subsidiaries liquidated and distributed to their sole stockholder, Honolulu, all their assets, subject to liabilities, in complete cancellation and redemption of all their stock. The subsidiaries then dissolved. Honolulu realized a loss upon the liquidation of the subsidiaries of $1,225,908.63, which amount was charged off on its books as a loss. No part of the loss was recognized as a deductible loss for income tax purposes under Section 112 (b) (6) of the Revenue Act of 1936, and no part of the loss was deducted by Honolulu in its 1936 return. (R. 33.) The loss of $1,225,908.63 is the result of deducting from $1,690,623.26, which is the total of the investments in the subsidiaries' stock and the unrepaid cash advances to the three subsidiaries by Honolulu, the amount of $464,-714.63, representing the actual cost, and also the value, of the assets, minus liabilities, of the three subsidiaries which Honolulu received (R. 34–35, 59).

The assets so received by Honolulu were entered on its books at the cost to the subsidiaries and these cost figures were used thereafter by Honolulu in computing depreciation, depletion,

and gain or loss on sale for purposes of determining its earnings or profits available for dividends after August 31, 1936 (R. 35).

The three subsidiaries sustained operating losses during the period from their incorporation to their dissolution, and the amount of their operating deficits on August 31, 1936, totaled $1,205,451.61. During the years 1928–1933, inclusive, Honolulu filed consolidated income tax returns and the operating losses of the subsidiaries for those years, totaling $769,103.67, were applied, for income tax purposes, in reduction of the net income of Honolulu (R. 36–37). But since Honolulu itself had an operating loss in 1933, the losses of the subsidiaries availed of in the consolidated returns amounted to $694,151.15 (R. 37–38).

On January 1, 1936, Honolulu had available for dividends earnings or profits accumulated after February 28, 1913, in the amount of $139,631.26. Honolulu's earnings or profits during the year 1936 amounted to $931,553.82, before deducting any portion of the loss realized upon liquidation of the subsidiaries on August 31, 1936, in the amount of $1,225,908.63, or before deducting the aggregate operating deficits of the subsidiaries in the amount of $1,205,451.61 (R. 38).

During 1936, Honolulu had outstanding 937,743 shares of stock, on which it paid four cash distributions of 25 cents per share during that year (R. 38). The distributions which taxpayer re-

ceived from Honolulu on shares of stock owned by him were in the total amount of $450 (R. 28-29).

On his income tax return for 1936, taxpayer reported the amount of $450 as taxable dividends (R. 28-29). Subsequently, he filed timely amended claims for refund of the tax paid by him for 1936. In these claims, disregarding items not here material, he asserted an overpayment of $51.84, based on the ground that only $18 of the $450 distribution, received during 1936, represented a taxable dividend, and that the remainder of $432 was not a taxable dividend because not paid out of earnings or profits accumulated by the corporation after February 28, 1913, or out of earnings or profits for the taxable year. The Commissioner rejected these claims and this suit was instituted to recover the amount of $51.84, plus interest thereon. (R. 2-11, 16-19, 20-23, 29-31, 56, 57-58.)

The District Court concluded that neither the loss sustained by Honolulu upon liquidation of its subsidiaries nor the operating deficits of the subsidiaries on the date of liquidation diminished the amount of Honolulu's earnings or profits which were otherwise available for distribution as dividends during 1936; hence, it approved the Commissioner's disallowance of the claim for refund (R. 60-61). The Circuit Court of Appeals affirmed (R. 71-74).

650763 45 -- 2

## ARGUMENT

Section 22 (a) of the Revenue Act of 1936 (Appendix, *infra*, p. 17) includes dividends within the definition of taxable gross income. Section 115 (a) (Appendix, *infra*, p. 20) defines a dividend as any distribution by a corporation to stockholders out of earnings or profits accumulated after February 28, 1913, or out of earnings or profits of the taxable year computed as of the close of the year, and Section 115 (b) (Appendix, *infra*, p. 20) provides that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits.

There is no question that Honolulu had sufficient earnings or profits[1] to cover the total cash distribution of $937,743 made by it during 1936, and hence that the distributions are taxable dividends in their entirety, unless its earnings or profits were reduced by the loss realized by it upon liquidation of its subsidiaries in 1936, or by the operating deficits of the subsidiaries existing at the time of the liquidation.

1. *The loss on liquidation of the subsidiaries did not reduce Honolulu's earnings or profits.*— The taxpayer's contention (Br. 53–57) that the

[1] Its earnings of $931,553.82 for 1936 alone, and $139,631.26 accumulated at the beginning of that year, total $1,071,185.08 (R. 38).

earnings and profits of Honolulu must be reduced by the loss of $1,225,908.63 which it realized on the liquidation of the subsidiaries,[2] although such loss was not recognized for tax purposes, is in direct violation of Article 115–3 of Treasury Regulations 94 (Appendix, *infra*, p. 23) applicable to the year 1936, which provides in part that—

> Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.

This Court has only recently approved an identical Regulation, promulgated under the Revenue Act of 1938,[3] as "reasonable and a valid exercise of the rule-making power." *Commissioner* v. *Wheeler*, No. 354, decided March 26, 1945.

The Regulation makes no exceptions and, applied here, directs without equivocation that Honolulu's loss on the liquidation in 1936 should not reduce its earnings or profits, for tax purposes, in any amount, since the loss was not recognized

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[2] This contention is presented as an alternative argument by taxpayer but is considered first here, since the taxpayer's principal contention, that the operating deficits of the subsidiaries reduced Honolulu's earnings, involves in part a discussion of the loss on liquidation. See *infra*, p. 14.

[3] Article 115–3 of Treasury Regulations 101. The Regulation originated in Article 115–1 of Treasury Regulations 86, promulgated under the Revenue Act of 1934.

to any extent in that year. Section 112 (b) (6) of the Revenue Act of 1936 (Appendix, *infra*, pp. 17–20).

Taxpayer does not discuss the Regulation but pitches his argument (Br. 53–57) on the unconstitutionality of Section 501 of the Second Revenue Act of 1940 (Appendix, *infra*, pp. 21–23) which incorporated the substance of the Regulation into the Internal Revenue Code and also amended all prior Revenue Acts to include the provision. But, as in the *Wheeler* case, it is unnecessary here to consider whether Section 501 violates the Fifth Amendment to the Constitution, because of its so-called retroactive features, since there was a valid controlling Regulation in effect when the liquidation occurred. Likewise, it is also unnecessary to consider the argument that Section 501 violates the Sixteenth Amendment to the Constitution, in that the taxpayer is required to pay a tax on capital. If the unconstitutional argument is intended to apply to the Regulation as well (although taxpayer's brief does not so state), then it is sufficient that this Court has approved the Regulation as resulting in a reasonable determination of earnings or profits for tax purposes.[4] In any event, it does not appear

[4] As pointed out by this Court in *Commissioner* v. *Wheeler*, *supra*, although the term "earnings or profits" has long been in the tax statutes, there has been no attempt to define its meaning by Congress until Section 501 of the Second Revenue Act of 1940 adopted the Regulation, first promulgated under the Revenue Act of 1934; this Court noted that the term

that taxation of the distribution in the taxpayer's hands would amount to an unconstitutional taxation of capital, since, regardless of the source of the distribution, his capital investment (his proportionate interest in the corporation, represented by his stock) remained the same after the distribution. Cf. 1 Mertens, *Law of Federal Income Taxation,* Sec. 9.29, p. 461. The taxpayer cannot, of course, show that this distribution to him will inevitably operate to prevent his ever regaining his total investment. His only constitutional interest is to prevent a tax on a return of his capital to him, and if he cannot show that, as a result of this distribution, he will not recover his capital, he has no ground for complaint. See Paul, *Selected Studies in Federal Taxation* (Second Series) pp. 151–152. Furthermore, since no one of the refund claims filed by the taxpayer (R. 12–23) alleges that Section 501 of the Second Revenue Act of 1940 or Article 115–3 of Treasury Regulations 94 (Appendix, *infra,* pp. 21–23) is unconstitutional, that question is not open to the taxpayer in a suit on the claims. *Real Estate-Land Title & Trust Co.* v. *United States,* 309 U. S. 13. And it should be noted that the argument that taxation of the distribution is a violation of the

"earnings or profits", in the tax sense, may not correspond exactly to taxable income, but it does not necessarily follow corporate accounting concepts either.

Sixteenth Amendment was first made in the petition for rehearing in the court below (Br. 53).[5]

2. *The operating deficits of the subsidiaries did not reduce Honolulu's earnings or profits.*—The taxpayer contends primarily (Br. 17–52) that the principle of *Commissioner* v. *Sansome,* 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, applies to permit reduction of Honolulu's earnings or profits by the operating deficits of the subsidiaries. The rule of the *Sansome* case is that where a new corporation acquires all the assets of a predecessor corporation in a tax-free reorganization, the accumulated earnings or profits of the predecessor pass intact to the new corporation as earnings, and remain available for distribution as dividends by the new corporation. In a nontaxable liquidation of a subsidiary corporation also, the earnings or profits of the subsidiary are "inherited" by the parent as earnings and are available for payment of dividends by it. Article 115–11 of Treasury Regulations 101 (Appendix, *infra,* pp. 25–26); *Robinette* v. *Commissioner,* 148 F. 2d 513 (C. C. A. 9th).

[5] On consolidated returns in years prior to 1936, Honolulu reduced its income by the operating losses of the subsidiaries in the amount of \$694,151.15 (R. 37–38). Having had the benefit of deducting this amount once, it may not again deduct those losses directly or indirectly. Consequently, the amount of Honolulu's deductible loss, in whatever year it may be recognized, will be no more than \$531,755.48 (\$1,225,908.63 minus \$694,151.15). *Ilfeld Co.* v. *Hernandez,* 292 U. S. 62; *McLaughlin* v. *Lumber Co.,* 293 U. S. 351.

Although this rule is firmly established in cases where the liquidated corporation had accumulated earnings or profits,[6] it has never been applied, as taxpayer concedes, in any case where the liquidated corporation had an operating deficit in lieu of earnings or profits. Furthermore, Section 115 (h) of the Revenue Act of 1938 (Appendix, *infra*, p. 21), the Regulations incorporating the *Sansome* principle (see Article 115–11 of Treasury Regulations 94 and 101 (Ap-

[6] See *United States* v. *Kauffmann*, 62 F. 2d 1045 (C. C. A. 9th); *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641 (C. C. A. 5th); *Fain* v. *Commissioner*, 76 F. 2d 1008 (C. C. A. 5th), certiorari denied, 296 U. S. 588; *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2d); *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2d); *Corrigan* v. *Commissioner*, 103 F. 2d 1010 (C. C. A. 3d), certiorari denied, 308 U. S. 576; *Georday Enterprises* v. *Commissioner*, 126 F. 2d 384 (C. C. A. 4th); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th); *Putnam* v. *United States* (C. C. A. 1st), decided May 25, 1945; *Barnes* v. *United States*, 22 F. Supp. 282 (E. D. Pa.); *Crocker* v. *Commissioner*, 29 B. T. A. 773; *Estate of McClintic* v. *Commissioner*, 47 B. T. A. 188.

*Campbell* v. *United States*, 144 F. 2d 177 (C. C. A. 3d), is an exception but the decision turned on the peculiar facts there involved.

Congress first incorporated the principle completely in Section 115 (h) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and has indicated its approval of the rule in connection with the 1938 and other Revenue Acts. S. Rep. No. 2156, 74th Cong., 2nd Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690), relating to Section 115 (h) of the Revenue Act of 1936; S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792), relating to Section 115 (h) of the Revenue Act of 1938; H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41, 42 (1940–2 Cum. Bull. 496, 526–527); and S.

pendix, *infra,* pp. 23–26), and the Congressional Committee reports approving the rule (footnote 6, *supra*) refer only to "earnings or profits" and do not indicate that the rule is to be extended to operating deficits which are the very antithesis of "earnings or profits." [7] The *Sansome* case was decided fifteen years ago, and the absence of any authority [8] that the rule applies to operating deficits is significant.

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Rep. No. 2114, 76th Cong., 3d Sess. (Part 1), p. 25 (1940-2 Cum. Bull. 528, 545–548), relating to Section 501 of the Second Revenue Act of 1940.

[7] The taxpayer suggests that both the Regulations (Br. 29–31) and S. Rep. No. 2114, 76th Cong., 3d Sess. (Part 1) p. 25 (1940-2 Cum. Bull. 528, 545–548) (Br. 45–46), use the term "earnings or profits" as referring to the earned surplus account and hence as embracing a negative balance (a deficit) in the account as well as a positive balance, or earnings. We find nothing to support this suggestion. Both the Senate Report and the Regulation relate to the amount of earnings or profits available for dividends in the tax sense and are in no way concerned with the accounting aspect of the question. Furthermore, it seems obvious that if the earned surplus account were meant, that term would have been used.

[8] In *Senior Investment Corp.* v. *Commissioner*, 2 T. C. 124, pending on review (C. C. A. 6th), one question was whether the corporation had a deficit in accumulated earnings or profits at the beginning of the tax year, so that it was entitled to a deficit credit against income for purposes of computing its surtax on undistributed profits under Section 26 (c) (3) of the Revenue Act of 1936, as amended by Section 501 (a) (2) of the Revenue Act of 1942. Prior to the tax year it had transferred some of its assets to another company in a reorganization at a time when, as it contended, it had a deficit. Both parties were in agreement that, if it had a deficit, the deficit was divisible between the two corporations, and the only issue was as to the method of division. Hence,

Moreover, there is a sound reason for applying the *Sansome* rule to earnings or profits and not to operating deficits. When a corporation acquires the assets of the liquidating corporation having accumulated earnings, it in fact receives assets which include the earnings. But where a corporation acquires the assets of a liquidating corporation having a deficit, the assets received may be less than they otherwise would have been if the deficit had not been incurred, but the assets actually transferred in liquidation are not reduced or affected in any way by the previously incurred deficits. Thus the acquiring corporation does not take over or inherit a deficit along with the assets.

Furthermore, the *Sansome* rule operates to prevent escape from taxation of the old corporation's earnings; without such a rule, earnings or profits which would be taxable as dividends if distributed by the old corporation could be transferred in a non-taxable transaction to another corporation and subsequently be distributed by it as a non-taxable distribution of capital. See *Putnam* v. *United States, supra; Murchison's Estate* v. *Commissioner, supra;* dissenting opinion of Judge Jones in *Campbell* v. *United States, supra.* Where the

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the Tax Court did not decide whether a deficit passes to a transferee corporation in a reorganization. The case presented a different question than does the instant one and was concerned only with the amount of the deficit retained by the transferor.

old corporation has a deficit, however, no such considerations arise. Rather the avoidance lies the other way; application of the rule to deficits would result in exempting Honolulu's earnings or profits from taxation as dividends upon their distribution.

The contention (Br. 35–46) that the operating deficits must reduce Honolulu's earnings or profits, in order to produce an equitable result and reflect the full loss sustained by Honolulu, proceeds on the accounting premise that a corporation's earnings or profits must be reduced, by one means or another, in the full amount of every loss it sustains, whether or not the loss is recognized and deductible for tax purposes. We submit that the premise is unfounded insofar as tax "earnings or profits" are concerned. The assumption that, if an unrecognized loss does not reduce earnings or profits directly, an indirect reduction must be made for the loss in the guise of subtracting the operating deficits which produce the loss,[9] is contrary to the expressed intent of Congress that earnings or profits shall be affected only as losses are recognized. Furthermore, although use of the transferors' bases for the assets

[9] As a bookkeeping proposition Honolulu did not acquire the operating deficits of the subsidiaries. The assets accounts of the subsidiaries were entered as assets on Honolulu's books at cost to the subsidiaries (R. 35). While Honolulu charged off, as a loss, its investment in the subsidiaries previously carried as an asset (R. 33), the subsidiaries' deficits as such do not appear on its books (R. 35).

acquired may mean that Honolulu will not be able, in the future, to deduct its loss on its investment in the subsidiaries in full, it has no cause for complaint since deductions are matters of legislative grace. Moreover, even though the losses may not be fully reflected in the corporation's tax accounting, the taxpayer, as a stockholder, is in a different position. Any actual losses suffered by his corporation will be reflected in his tax accounting when he disposes of his stock.

Since Section 115 (a) (2) defines a dividend as a distribution from earnings of the taxable year, Honolulu would not have been able to reduce its earnings of $937,430 for 1936 by the amount of its own deficit, if it had had one, at the beginning of that year, in determining the earnings available for payment of dividends at the end of 1936. It seems, likewise, that it should not be permitted to diminish its 1936 earnings by the amount of the deficits of the subsidiaries incurred prior to 1936. If it be assumed *arguendo* that the operating deficits of the subsidiaries passed to Honolulu, we submit that only those deficits incurred by the subsidiaries in 1936 could apply against Honolulu's own 1936 earnings. Since the record fails to show these amounts, it follows that at least Honolulu's earnings of $937,430 for 1936 were available for the dividend paid to its stockholders in that year.

## CONCLUSION

There is no conflict of decisions and the instant case was correctly decided in accordance with the controlling authorities. The petition for a writ of certiorari should, therefore, be denied.

Respectfully submitted.

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JUNE 1945.

## APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, of the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) *Exchanges solely in kind.*—

* * * * *

(6) *Property received by corporation on complete liquidation of another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. For the purposes of this paragraph a distribution shall be considered to be in complete liquidation only if—

(A) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 per centum of the total

number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), and was at no time on or after the date of the adoption of the plan of liquidation and until the receipt of the property the owner of a greater percentage of any class of stock than the percentage of such class owned at the time of the receipt of the property; and

(B) no distribution under the liquidation was made before the first day of the first taxable year of the corporation beginning after December 31, 1935; and either

(C) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the stockholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock, shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(D) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, no distribution under the

plan shall be considered a distribution in complete liquidation.

If such transfer of all the property does not occur within the taxable year the Commissioner may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such three-year period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, the assessment and collection of all income, war-profits, and excess-profits taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this paragraph shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for the purposes of this paragraph a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (of one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (i) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, upon an exchange described in paragraph (4) of this subsection, and (ii) the complete cancellation or redemption under the plan, as a result of

exchanges described in paragraph (3) of this subsection, of the shares not owned by the taxpayer.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1938, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. * * *

(b) *Effective date of amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under prior acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or

was theretofore determined by, the Board of Tax Appeals, or any court of the United States. (26 U. S. C. 115.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized * * *
>
> ART. 115-11. *Effect on earnings or profits on certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received

without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1936, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any corporation. In such

cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 115-11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

* * * * *

(2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in

section 112 (b) (6) of the Revenue Act of 1936 or section 112 (b) (6) of the Revenue Act of 1938.

*   *   *   *   *

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

*   *   *   *   *

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# In the Supreme Court
OF THE
# United States

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OCTOBER TERM, 1944

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**No. [redacted]** 85

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| LORIN A. CRANSON, | |
| | *Petitioner,* |
| vs. | |
| THE UNITED STATES OF AMERICA, | |
| | *Respondent.* |

**On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.**

## PETITIONER'S REPLY BRIEF.

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## Subject Index



## Table of Authorities Cited

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*Petitioner,*
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*Respondent.*

**On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.**

## PETITIONER'S REPLY BRIEF.

1. **THE GROUNDS ASSERTED BY PETITIONER IN HIS REFUND CLAIMS ARE SUFFICIENT TO SUPPORT ALL CONTENTIONS ADVANCED BY PETITIONER IN THIS SUIT.**

On page 9 of its brief the Government makes the statement that

> "* * * since no one of the refund claims filed by the taxpayer (R. 12-23) alleges that Section 501 of the Second Revenue Act of 1940 or Article 115-3 of Treasury Regulations 94 (Appendix, *infra,* pp. 21-23) is unconstitutional, that question is not open to the taxpayer in a suit on the

> claims. *Real Estate-Land Title & Trust Co. v. United States,* 309 U. S. 13."

The petitioner's contentions with respect to the unconstitutionality of Section 501 of the Second Revenue Act of 1940 and Article 115-3 of Treasury Regulations 94 are advanced in connection with petitioner's alternative argument that the *loss* actually realized by Honolulu upon the liquidation of its subsidiaries reduced Honolulu's earnings and profits available for dividends.

With respect to this alternative contention, petitioner's claims for refund were specifically based on the ground that 96% of the dividends received from Honolulu Oil Corporation in 1936 were exempt from tax and that "In computing the Corporation's earnings available for taxable dividends, it is necessary to take into account * * * losses upon dissolution during 1936 of wholly owned subsidiaries." (R. 18, 22.)

In *Real Estate-Land Title & Trust Co. v. United States,* 309 U. S. 13, cited by the Government, this Court decided that a claim for refund based solely on the ground that the taxpayer was entitled to an allowance for obsolescence will not support a suit based on the ground that the taxpayer was entitled to a deduction for a loss sustained and not compensated for by insurance or otherwise.

It is apparent that in the instant proceeding the petitioner has not departed from the ground for refund asserted in his refund claim. It is elementary that in support of that ground the petitioner may advance any reasons whatever. It has never been

held that a taxpayer must set forth his entire legal argument in his refund claim.

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2. SECTION 115(h) HAS NO APPLICATION TO THIS CASE.

On pages 11 and 12 of its brief the Government makes the statement:

> "Furthermore, Section 115(h) of the Revenue Act of 1938 * * * refer only to 'earnings or profits' and do not indicate that the rule is to be extended to operating deficits * * *."

And in a footnote on page 11 it is stated:

> "Congress first incorporated the principle (the Sansome rule) completely in Section 115(h) of the Revenue Act of 1938 * * *."

Section 115(h) of the Revenue Act of *1936,* which is the statute controlling the disposition of the present case, reads as follows:

> "**(h) Effect on earnings and profits of distributions of stock.**—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—
>
> "(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or
>
> "(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the

meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

"As used in this subsection the term 'stock or securities' includes rights to acquire stock or securities."

Section 115(h) merely provides that the distribution by a corporation of its own stock or securities, or stock or securities of another corporation, shall not be considered a distribution of earnings or profits if the distribution is not taxable to the recipient. The purpose of this section was to prevent a corporation from making a tax-free distribution to its stockholders of stock or securities and at the same time contend that it had reduced its earnings available for dividends.[1] Section 115(h) obviously has no bearing whatever on the transfer of corporate earnings in non-taxable reorganizations.

In the Revenue Act of 1938 the words "or of property or money" were inserted after the words "another corporation" in the first few lines of section 115(h), so that it applied not only to a distribution of stock or securities but also of property or money. But it is apparent that the addition of these words in 1938 did not result in this section of the statute incorporating the principle of the *Sansome* case.

[1]Section 115(h) appeared in its original form as section 203(g) of the Revenue Act of 1924. The reasons for its enactment appear on page 9 of a statement prepared for the use of the Senate Committee on Finance (68th Congress, 1st Session), entitled "Statement of the Changes made in the Revenue Act of 1921 by H. R. 6715 and the Reasons Therefor."

### 3. THE AMOUNT OF HONOLULU'S DEDUCTIBLE LOSS IS NOT IN ISSUE.

In the footnote on page 10 of the Government's brief it is stated that Honolulu may not again deduct the losses of the subsidiaries taken in prior years on consolidated income tax returns and that in whatever year the loss may be recognized it will be limited in amount. As pointed out in petitioner's brief, page 37 *et seq.*, the recognition of the loss realized by Honolulu on liquidation of the subsidiaries is not merely deferred—it will *never* be recognized for tax purposes. It is by virtue of this very fact that it is claimed that Honolulu's earnings available for dividends, as distinguished from its *taxable net income*, must be reduced at the time of liquidation by the loss actually realized, in order to avoid a serious permanent overstatement of earnings available for dividends.

Dated, San Francisco, California,
July 2, 1945.

LEON DE FREMERY,
*Attorney for Petitioner.*

*Due service and receipt of a copy of the within is hereby admitted*

*this*........................................*day of July, 1945.*

.................................................................

Solicitor General of the United States,
*Attorney for Respondent.*